Jean-Pierre Roth: Review of the Swiss economy in 2007 and the outlook for 2008

Speech by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank and Chairman of the Board of Directors of the Bank for International Settlements, at the General Meeting of Shareholders of the Swiss National Bank, Berne, 25 April 2008.

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Mr President of the Bank Council
Dear Shareholders
Dear Guests

As history has shown, and the President of the Bank Council has reminded us just now, celebrations to mark our various anniversaries have often taken place amid difficult circumstances.

Such was the case in 2007, when confidence in the quality of numerous financial products began to fade from August onwards in the wake of the US real estate crisis – subsequently placing a substantial provisioning burden on international banks and leading to a crisis of confidence on the markets. A worsening of the economic outlook and major stock market corrections then ensued.

Nevertheless, 2007 as a whole can still be regarded as a successful year in economic terms, with global economic growth settling in at around 5%. This excellent performance is mainly attributable to the continued momentum of the emerging economies, notably in Asia, although favourable financial conditions also played a positive role until the middle of the year.

Global economic performance was less homogeneous than in 2006, however. Although growth remained high in the emerging economies and exceeded the long-term trend in Europe, economic activity in the US slowed considerably in autumn on the back of the credit crunch on the property market.

The last few months of 2007 were characterised by the emergence of considerable uncertainties regarding the future path of the global economy, with the latest energy price hikes and, of course, the destabilisation of the financial markets in autumn being the main sources of concern.

Switzerland has not remained unscathed amid all this turmoil. Since the summer, we have seen substantial stock market corrections and a return to lower-risk investments, particularly in Swiss francs. However, we experienced these turbulences during a very dynamic phase in our economic cycle. Despite the volatile climate of recent months, the Swiss economy has continued to enjoy sustained growth.

For the fourth year in succession, real GDP growth was significantly higher than the long-term average, reaching 3.1%. We owe this gratifying result to the extremely broad-based nature of Swiss economic growth. As already in 2006, the global economy and the performance of the Swiss franc facilitated exports, accounting for a jump of some 10% in this sector. What is more, robust domestic demand also played a role this time round. Significant increases in real salaries and the continued labour market upturn had a positive impact on private consumption, while the robust financial health of the corporate sector coupled with a rosy business outlook helped to stimulate investment. Final domestic demand thus rose 2% in 2007, compared to 1.7% in the prior year.

Thanks to burgeoning demand, employment was up sharply, with the unemployment rate edging down to 2.6% in seasonally adjusted terms by December. The Swiss economy is thus experiencing a period of virtually full employment and has been able to benefit from the flow of workers from the European Union and the flexibility this brings.

The economic figures for 2007 are all the more pleasing given that prices have remained stable despite the hike in commodity prices. Over the year as a whole, prices increased by 0.7% on average. However, by December, inflation was up 2% – an acceleration primarily attributable to the sharp jump in the price of oil.

In such a favourable climate, it was important for monetary policy not to stimulate the economy any further. By persisting with excessively low interest rates, we could have aggravated inflationary risks and thereby disturbed the macroeconomic equilibrium. The SNB therefore maintained its monetary normalisation course by lifting the Libor target range by 25 basis points on three occasions. The three-month Libor thus rose from 2.1% at the beginning of the year to 2.75% in September. In view of the considerable financial uncertainty and the effect this was having on growth prospects for 2008, we subsequently left the target range unchanged and stabilised the Libor at the 2.75% mark. We have since maintained this position.

Turmoil on the financial markets

The financial storm of the last nine months has challenged our assessment criteria. Such turmoil poses considerable risks for the future.

Before I deal with these issues, please allow me first to look at the factors which have brought us to this situation.

After several years of rising home prices in the United States, there was a trend reversal to the downside which hit the high-risk sub-prime mortgage segment hard. It was when credit rating agencies began a massive downgrading of sub-prime mortgage-backed securities that the global financial markets realised the full enormity of what was happening. During the summer months of 2007, the prices and liquidity of these securities plummeted. This turn of events alarmed investors. Risk premiums subsequently increased, with uncertainty as to the extent of the losses incurred by banks triggering a general crisis of confidence among financial market participants. Liquidity on the major monetary markets became scarce and there was a return to volatility on the stock markets.

Repercussions for Switzerland

Switzerland quickly felt the storm due to the exposure of its financial sector.

First, our two big banks saw their profitability fall sharply in the second half of 2007. Losses made in connection with their investment activities in the United States were a decisive factor in this respect. One of the big banks even required fresh injections of capital, such was the extent of the losses it suffered. The private banking sector and domestic banking activities continued to flourish, however.

Second, the turbulent environment handicapped the money market and led to a widening of the spread, i.e. by means of an unwelcome interest rate hike. The SNB responded immediately by relaxing its lending conditions for banks. Contrary to certain suggestions, this measure was not intended as a means of increasing the amount of liquidity in circulation on a permanent basis. After all, inflationary pressure would potentially rise given such a scenario. Instead, we acted in a flexible way and adjusted our maturities in accordance with the demands in the lending market so as to provide this market with the buffer it needed. We have consequently introduced three-month loans, whereas the terms we offered previously were never longer than 30 days. We also took joint action with other central banks and provided US dollar liquidity to our counterparties – the first time we have ever taken such a step.

The gradual tightening of lending conditions within our domestic market is a third factor, albeit one which is still to fully materialise. Indeed, the fear that the liquidity requirements of the two big banks may be having a detrimental impact on credit volumes in Switzerland cannot be excluded. However, the rest of the Swiss banking sector – which accounts for almost two-thirds of Switzerland's domestic credit supply – posted excellent results in 2007, thereby helping to limit the burden of risk. Furthermore, our figures show that there has so far been no impact on lending growth. Nevertheless, a gradual revision of banks' credit risk evaluations appears the likely scenario, simply given the economic uncertainty of recent months. Banks may consequently raise their interest rates for commercial loans or ask their customers to provide additional collateral. The sharp increase in premiums seen on the bond market in recent months would seem to back up such a trend, at least as far as the major corporates are concerned. Such a development might then have a knock-on effect on lending conditions for SMEs. At present, the SNB is carrying out a survey among banks in order to gain a better idea of the direction in which lending conditions are heading.

Lessons from these turbulences

We can learn a lot from the period of turbulence we are currently experiencing with regard to banking supervision and the stability of the financial system. The Financial Stability Forum (FSF) submitted a number of measures to the G7 countries aimed at enhancing the resilience of financial markets. The SNB was an active partner in drafting this report.

Allow me to elaborate on this topic.

First, it is astounding that a problem which appears to be confined to one single segment of the mortgage market in one single country could have resulted in crisis of global proportions. We feel that this situation has not only come about because of the globalisation of the financial markets, but also because international banks have become increasingly vulnerable over the last few years – vulnerable because of their thirst for profit and their underestimation of the ensuing risks.

Second, the banks' risk measuring and management instruments could not cope with the crisis. Consequently, the actual losses incurred in the area of mortgage-backed securities (MBS) clearly surpassed the potential level calculated by the sophisticated statistical models, and the liquidity haemorrhage suffered by the banks was greater than the most pessimistic scenarios had suggested. In other words, the risk measuring systems failed despite the fact that they were being monitored by the best-informed experts around. This summary may sound a little harsh, but is not intended to put the blame on the banks. Instead, it illustrates that no model can do complete justice to the complexity of financial instruments and the economic environment in which banks operate these days.

Third, the events of the last few months raise question marks about the efficiency of the banking supervision standards applied so far. The call for more sophisticated risk measurement systems, supervision and regulation of banks is understandable. There is room for improvement in these areas, and it must be exploited. Nevertheless, it should be pointed out that more extensive regulation on its own represents an unsatisfactory response to the growing complexity of banking activities. Through the events of recent months, we are called upon to learn the lessons from the banks' limited ability to measure risk and – as a logical consequence – the limited scope afforded to the relevant supervisory authorities. Despite the welcome improvements provided by Basel II, it is naive to assume that weighted capital requirements can guarantee fool-proof bank capitalisation assessments. There is a substantial margin of error which must be taken into consideration. In order to take account of all the variables, a tightening of the traditional requirements in the area of the bank capitalisation, liquidity and indebtedness is necessary. For a financial centre like ours – which includes international banks whose private banking arms generate substantial revenue and consequently rely on having a spotless reputation – such action is vital.

Finally, the banks that have been buffeted by the financial storm must take a careful look at the various ways in which they apply corporate governance. In particular, they should examine the role of their respective boards of directors in carrying out the necessary checks and balances to ensure efficient risk management, and they should correct the excesses of their remuneration systems in a manner that does not put short-term results ahead of the long-term performance. The latter aspect has been the subject of debate for some years already, and now it is time for answers.

Impact on monetary policy

The turmoil on the financial markets has also had implications with regard to monetary policy. The SNB has taken care to ensure that the fallout from this crisis does not lead to an undue tightening of credit conditions.

The increase in the risk premiums we saw last autumn has resulted in a de facto tightening of financing conditions for banks and companies. By exerting a moderating influence on interest rates, monetary policy can prevent risk premium hikes from triggering a slowdown in economic activity. The great advantage of the SNB's operational objective – i.e. a target range for the three-month Libor – is that it takes account of the risk premiums banks face in their refinancing transactions. Since the banks pass on these risk premiums to their customers via their lending conditions, the Libor reflects the degree of restrictiveness on the lending market. Fully aware of this fact, the SNB has been aiming for a Libor at around the 2.75% mark in recent months. Given the current circumstances, this is a rate which we deem necessary to ensure price stability in the medium term.

Resurgence of inflationary risks

The financial storm should not make us forget that it is our mandate to ensure price stability in the medium term. In this regard, 2007 saw a worsening in the situation due to the sharp increase in commodity prices. The indicators reflecting these price rises registered a growth rate of between 15% and 40%, while the price for crude oil shot up nearly 50% in one year. Even food prices rose by more than 20% on the international markets. Such price increases are all the more remarkable given that these prices had tended to stagnate in recent years.

This jump in the price of commodities was mainly attributable to the continuous growth in domestic demand in the emerging markets and low extraction and production capacity. In our opinion, this situation is not likely to change in any direction in the short term.

Although partially offset by the weak US dollar, the rise in the oil price during the final quarter of 2007 triggered a sharp increase in inflation – from 0.7% in September to 2% in December. The price rises of other commodities were also significant, but they only had a minor impact on inflation in Switzerland. In fact, commodities are not directly included in the reference basket used to calculate the price index, which means that their price increases only had a minor impact in this respect. However, the indirect effects, i.e. higher prices for goods and services as a result of higher production costs, constitute a much more serious inflationary risk. Having said this, the related impact last year was modest because many companies chose not to pass on their higher costs to consumers, given the considerable competitive pressure in numerous markets. Moreover, the relatively moderate increase in wage costs and gains in productivity over the last few years allowed companies to absorb a good part of the additional costs they had incurred as a result of higher commodity prices.

However, at the end of 2007 and during the first quarter of this current year, companies became less reticent and began to make more frequent and more significant price adjustments. The moderating factors that have been at play until now have gradually lost their impact. Inflation thus reached 2% in December and has even exceeded this level in recent months. We cannot rule out the possibility that costs will increasingly be passed on in 2008.

My fears are based on two particular aspects. First, the rapid rise in the cost of labour at the end of 2007 put pressure on margins. At the same time, productivity gains became less marked as companies reached the limits of their production capacity. Therefore, adjustments in the margins will probably have to be made. Second, the current favourable business climate encourages companies to reinstate the margins they had previously cut in order to maintain their market share amid stiff competition. Some companies may pass on a disproportionate share of the higher costs they have incurred in the past.

The SNB does not underestimate these risks, but is nevertheless confident with regard to the inflation outlook in the medium and long term. In essence, our confidence is based on the fact that monetary policy of the past three years has been successful in gradually normalising the interest rate level. Since 2004, we have lifted the Libor target range in ten steps to bring the interest rate to a level that is in line with price stability in the medium term. Thanks to this preventive approach, the inflation outlook has not deteriorated despite the inflationary bouts of recent months.

Moreover, the performance of our monetary aggregates strengthens our belief that price stability can be maintained. Contrary to what we see in neighbouring countries, growth in Switzerland's monetary aggregates has been compatible with stable medium and long-term inflation for a number of years already. Successive interest rate hikes have created the conditions for transfers from sight and savings deposits to term deposits, which generally earn better returns. Thus, in 2007, M1 and M2 continued declining, while M3 recorded only modest growth. Consequently, the money overhang which existed since 2003 has now dissipated – a development which bodes well for future price stability.

Finally, the foreign exchange market has largely corrected the previous slide in the Swiss franc against the euro, which had made imports more expensive. The Swiss franc's rebound creates a more favourable environment for the preservation of price stability in the medium term. This change in monetary conditions enabled us to leave interest rates unchanged at our monetary policy assessment in March.

Mixed outlook for 2008

Even though Switzerland's economic performance is still excellent, 2008 is fraught with considerable uncertainties. The situation on the financial markets has not yet stabilised, and the global economy is slowing. Our economy, with its important financial sector and strong presence on the international markets, will not remain unscathed. In addition, the increase in commodity prices, in particular the price of oil, is triggering an inflationary effect.

These different factors pose a predicament in terms of monetary policy, and the resultant uncertainty this causes is not exactly beneficial for Swiss companies. I have every confidence, however, that Switzerland will navigate these troubled waters without any major problems. On the one hand, our economy is very competitive. Thanks to the reforms implemented in recent years, Switzerland is well placed to adjust to the needs of the global economy and cope with pressure on the foreign exchange markets. On the other hand, our careful policy in favour of a gradual normalisation of interest rates, which we have been pursuing since 2004, has resulted in a steady tightening of monetary conditions and should ensure price stability in the medium term.

On this positive note, I would like to close my remarks. Thank you for listening and, above all, thank you for supporting the National Bank in its efforts to ensure monetary stability in Switzerland.